

ANALYSIS OF ORIGINAL BILL

Author: Davis Analyst: Jeff Garnier Bill Number: AB 1991

Related Bills: See Legislative History Telephone: 845-5322 Introduced Date: 2-17-98

Attorney: Doug Bramhall Sponsor:

SUBJECT: Increase Self-Employed Health Insurance Deduction to 80%/
Disallow Amounts Paid to National Tobacco Settlement Fund

SUMMARY

Under the Personal Income Tax Law (PITL), this bill would increase the existing deduction of 25% of a self-employed individual's cost for medical insurance to the federal percentages in effect as of January 1, 1997 (phase in to 80% in 2006). Additionally, under the PITL and the Bank and Corporation Tax Law (B&CTL), this bill would disallow a deduction for any amounts paid to the National Tobacco Settlement.

EFFECTIVE DATE

This bill would become effective for taxable or income years beginning on or after January 1, 1998.

LEGISLATIVE HISTORY

1997 - AB 305, AB 230 and AB 1364
1998 - SB 1928, AB 2107, AB 2131 and AP 98-01

SPECIFIC FINDINGS

INCREASE OF SELF-EMPLOYED HEALTH INSURANCE COST DEDUCTION

Existing Federal law provides for a deduction in determining adjusted gross income (AGI) of 45% (effective for 1998) of a self-employed individual's cost for health insurance. Federal law also incrementally allows the deductible percentage to increase to 100% beginning in the year 2007. The percent is increased as follows:
45% in 1998 and 1999,
50% in 2000 and 2001,
60% in 2002,
80% in 2003 through 2005,
90% in 2006, and
100% in 2007 and thereafter.

DEPARTMENTS THAT MAY BE AFFECTED:

___ STATE MANDATE

___ GOVERNOR'S APPOINTMENT

Board Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
___X___ PENDING

Agency Secretary Position:

___ S ___ O
___ SA ___ OUA
___ N ___ NP
___ NA ___ NAR
DEFER TO ___

GOVERNOR'S OFFICE USE

Position Approved ___
Position Disapproved ___
Position Noted ___

Department Director Date
Gerald H. Goldberg 4/6/98

Agency Secretary Date

By: Date

Prior to the enactment of the **federal Taxpayer Relief Act of 1997** (TRA), the federal deductible percentage increased from 25% in 1996 to 80% in 2006.

For taxable years beginning in 1997, the deductible percentage for self-employed health insurance costs, **under California law**, was 40% (SB 455, Stat. 1997, Ch. 611). For taxable years beginning on or after January 1, 1998, the California percentage reverts to the pre-1997 percentage of 25% (SB 1233, Stat. 1997, Ch. 612).

Under both federal and state law, the cost of health insurance incurred by a self-employed individual that is not deductible in determining adjusted gross income (AGI) may be taken as an itemized medical deduction. Itemized medical deductions are limited to the amount that exceeds 7.5% of the taxpayer's AGI.

Additionally, **under both** federal and state law, health insurance costs include premiums paid for health insurance of the taxpayer, taxpayer's spouse and dependents. A deduction for self-employed insurance costs is not allowed if the taxpayer or taxpayer's spouse is eligible to participate in any employer subsidized health plan. The deduction is limited to the extent of the individual's federal earned income from the business from which the health coverage was established.

Under the PITL, **this bill** would increase the percentage of health insurance deductible by self-employed individuals from the 1998 25% amount to 80% in 2006, as follows:

45% in 1998 through 2002,
50% in 2003,
60% in 2004,
70% in 2005
80% in 2006, and thereafter.

These phase-in amounts follow the federal phase-in amounts prior to the enactment of the TRA of 1997.

Implementation Considerations

Implementing this bill would require some changes to existing tax forms and instructions, which could be accomplished during the normal annual update.

FISCAL IMPACT

Departmental Costs

Insignificant departmental costs would be incurred implementing the bill.

Tax Revenue Estimate

Revenue losses from this provision are estimated as shown in the table.

Fiscal Year Cash Flow Impact Effective 1/1/98 Enactment Assumed After June 30, 1998 \$ Millions								
1998-9	1999-00	2000-1	2001-2	2002-3	2003-4	2004-5	2005-6	2006-7
(\$17)	(\$16)	(\$19)	(\$21)	(\$26)	(\$38)	(\$59)	(\$86)	(\$112)

This provision would be effective with taxable years beginning after December 31, 1997, with enactment assumed after June 30, 1998. Losses would occur under the PITL.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact of this provision would be determined by the number of self-employed individuals who claim additional insurance deductions, and the average marginal tax rate applicable to deduction amounts.

This estimate was developed in the following steps. First, the number of California resident taxpayers who currently claim the self-employed insurance deduction was calculated from returns filed for 1995 (425,000). Secondly, the current deduction amount of 25% was calculated to be \$839 on average for returns filed in 1995, making the average annual health insurance premium \$3,356 (\$839 x 4). Third, the estimated number of qualified taxpayers for 1995 was grown at 5% per year to yield 492,000 qualified taxpayers for 1998. Fourth, the insurance premium was grown at 7% per year to yield an average \$4,111 insurance premium for 1998. Fifth, the total deduction at 25% was calculated to be \$506 million for 1998 and the amount deducted for health insurance premiums on Schedule-A was calculated to be \$388 million, generating a total deduction amount under current law of \$894 million. At an average marginal tax rate of 4.5% (computed by the PIT microsimulation model for self-employed individuals), the current law revenue loss for 1998 is \$40 million. Sixth, the total deduction was calculated at 45% at a 4.5% marginal tax rate for 1998, generating a \$41 million tax loss and the amount deducted for health insurance premiums on Schedule-A was calculated to be \$13 million, generating a total \$54 million tax loss. These steps resulted in a 1998 estimate of an additional \$14 million tax loss. The 1998-9 fiscal year estimate consists of the 1998 tax loss (\$14 million) and 25% of 1999 reflecting reduced estimated tax payments. Seventh, the total deduction was then calculated at various percentages from 45% phasing up to 80% by the year 2006. Losses were grown to reflect a combined annual growth of 5% (qualified taxpayers) and 7% (premiums) based on current historical averages.

DISALLOW AMOUNTS PAID TO NATIONAL TOBACCO SETTLEMENT FUND

Federal and California law allow for the deduction of ordinary and necessary business expenses.

This bill would specifically disallow a deduction for amounts paid to National Tobacco Settlement Fund (NTSF), irrespective of whether such amounts were otherwise ordinary and necessary business expenses.

The Universal Tobacco Settlement Act (Senate Bill 1414, S. 1414), which would establish the NTSF, as of the date of this analysis, has not been enacted into law. The author of S. 1414, Senator McCain, has only obtained four co-sponsors. In its present form, S. 1414 would require tobacco companies that are a party to settlement to pay approximately \$368 billion to the NTSF over 25 years. S. 1414 would specifically provide that all payments made to the NTSF shall be considered to be ordinary and necessary business expense in the taxable year paid. S. 1414 imposes various penalties on the tobacco companies failing to perform various acts outlined in the settlement. The penalties are payable to the NTSF. Generally, penalties paid to a government entity are not deductible for income tax purposes under the Internal Revenue Code or the Revenue and Taxation Code. S. 1414 would permit the deduction for federal law of the penalties paid to the NTSF. Absent S. 1414's provision treating all payments to the NTSF as ordinary and necessary business expense, a portion of the payments made to the NTSF would be deductible under the current Internal Revenue Code. Thus, a portion of the payments made to the NTSF also would be deductible under the Revenue and Taxation Code (in absence of this bill) since California generally conforms to Section 162 of the Internal Revenue Code (allowing the deduction of ordinary and necessary trade or business expenses.)

It is not known if S. 1414 will contain a provision preempting California from enacting any laws contrary to the National Tobacco Settlement. However, Congress has not historically compelled states to allow a class of taxpayers a specific tax deduction or credit.

Because S. 1414 has not been enacted into law, the provision of this bill not allowing a deduction for payments made to the NTSF does not impact the Franchise Tax Board at present.

Implementation Considerations

Implementing this bill would require some changes to existing tax forms and instructions, which could be accomplished during the normal annual update.

FISCAL IMPACT

Departmental Costs

Insignificant departmental costs would be incurred implementing the bill.

Tax Revenue Estimate

Based on S. 1414 enactment and other assumptions discussed below, this provision would generate revenue gains as shown below:

Estimated Revenue Impact of No Deduction for Payments Under the Federal Universal Tobacco Settlement Act [\$ In Millions]		
1998-99	1999-00	2000-01
\$18	\$18	\$19

It is assumed the bill would be effective with income years beginning after December 31, 1997, with enactment assumed after June 30, 1998. It is further assumed the "initial payment" (as defined in S. 1414) by each industry source would be made on the date of enactment. The impact would be largely under the B&CTL.

Estimates above do not reflect any possible taxpayer behavior to reduce or eliminate tax nexus in California (e.g., selling to non-California, non-unitary wholesalers only). This analysis also does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Revenue Discussion

The revenue impact of this proposal would be determined by (1) the amount of initial and subsequent annual payments by each participating tobacco manufacturer denied as an otherwise ordinary and necessary business deduction, (2) each participating manufacturer's average apportionment factor, and (3) the franchise tax rate of 8.84%.

The estimate is based on two significant assumptions: (1) S. 1414 as currently drafted becomes law, and (2) annual settlement payments would be deductible as ordinary and necessary business expenses under current state law. Proposed settlement payments totaling \$368.5 billion over 25 years were broken down to an annual amount in the pattern laid out in S. 1414. By comparing tobacco-related sales for each assumed participating manufacturer to total industry sales, the approximate annual payment to be made by each tobacco manufacturer with nexus in California was calculated. Each manufacturer's estimated annual payment was multiplied by its average apportionment factor to approximate the amount of deduction denied. Denied deductions are projected to be roughly \$230 million after apportionment for 1998. Applying the franchise tax rate of 8.84% to the sum of deductions denied derives the estimated revenue gain on a liability year basis.

BOARD POSITION

Pending.